UNITED
NATIONS

E

Economic and Social Council

Distr.
GENERAL

E/C.10/AC.3/1992/5/Add.3
4 February 1992

ORIGINAL: ENGLISH

COMMISSION ON TRANSNATIONAL CORPORATIONS
Intergovernmental Working Group of Experts
on International Standards of
Accounting and Reporting
Tenth session
5-13 March 1992
Item 3 (b) of the provisional agenda*

PROGRAMME OF WORK OF THE INTERGOVERNMENTAL WORKING GROUP OF EXPERTS ON INTERNATIONAL STANDARDS OF ACCOUNTING AND REPORTING: DISCUSSION OF ACCOUNTING ISSUES ARISING DURING PRIVATIZATION, INCLUDING INDIVIDUAL COUNTRY CASE-STUDIES

Accounting problems arising during privatization in Germany

Report of the Secretary-General

SUMMARY

Germany is in the unique position of having experienced privatization under two greatly different macroeconomic structures - the market economy of the former Federal Republic of Germany and the planned economy of the former German Democratic Republic, which is now in rapid transition to a market economy. Prior to the unification of Germany, the primary motive of the Government in undertaking to denationalize specific enterprises was to reduce budget subsidies in economic sectors where there were no longer rational justifications for government ownership. To attain this objective large placements of shares were made using national and international capital markets, which were well-developed in the former Federal Republic of Germany. With the currency reform of the former German Democratic Republic on

* E/C.10/AC.3/1992/1.

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1 July 1990, the Federal Government's privatization programme has become an important part of the transition process from a planned to a market economy. The Government has found that privatization could be achieved most rapidly by sales of small businesses to the current managers and employees and of larger enterprises to other established companies. Capital adequacy of newly privatized entities in the former German Democratic Republic is an important issue, which the Government is addressing through the well-established financial infrastructure of Germany and through investment subsidies. Prior to the privatization of an enterprise in the former German Democratic Republic, an opening balance sheet is prepared on a "going concern" basis with amounts revalued from their historical basis to current values, as prescribed by German law. There was considerable delay in completing all the opening balance sheets because of a number of accounting problems, particularly in the area of valuation.

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INTRODUCTION 1/

1. The privatization process in the former German Democratic Republic differs totally from that in the former Federal Republic of Germany. In contrast to other countries, in the former Federal Republic of Germany, there was no wave of nationalization after the Second World War. The business holdings of the Government of the Federal Republic of Germany were therefore comparatively small. The former Federal Republic of Germany none the less had considerable holdings inherited from the former Third Reich and the former Republic of Prussia.

2. With currency reform in the former German Democratic Republic on 1 July 1990, the Government was obliged to shoulder the burden of 40 years of a centrally planned economy and with it responsibility for practically all business property in that country. From 1972 on, more than 90 per cent of economic activity in the former German Democratic Republic took place in state enterprises with detailed production targets and fixed prices and a complicated system of charges, subsidies and external trade. The mentality was that a product was worth whatever it cost to make it. The system's inherent inability to coordinate complex economic activities and to make use of economic incentives resulted in poor economic vigour and weak productivity in the former German Democratic Republic.

I. FACTORS INFLUENCING THE SELECTION OF PRIVATIZATION METHODS

A. Objectives of privatization

1. Former Federal Republic of Germany

3. As early as the 1960s, the Government of the former Federal Republic of Germany had begun to reduce its shareholdings in industrial enterprises. This occurred in internationally acclaimed privatization measures that achieved broad dispersion of the ownership of the shares - Preussag (1959), Volkswagen (1961) and VEBA (1965). At the forefront of the privatizations has been the goal of reducing state business activity as much as possible and restricting public sector activity to the essential functions of Government.

4. On 26 March 1985, the former Federal Republic of Germany adopted an overall concept for a policy on privatization and public ownership. The overall concept contained guidelines for the privatization and management of holdings in a market economy in which the public enterprises are embedded in a pluralistic and mainly private ownership structure.

5. Specific goals of privatization have included:

(a) Developing and strengthening private business initiatives;

(b) Ownership of shares by the public with as broad a dispersion as possible;

(c) Employee stock ownership;

(d) Enlarging the capacity of the stock exchanges and strengthening Germany's position as a financial centre.

2. Former German Democratic Republic

6. After the Second World War, a planned economy was imposed in the former German Democratic Republic. At that time, nationalization of the means of production and the introduction of central control of the economy largely eliminated private property and private entrepreneurial initiative. After the expropriation of key branches of the economy during the period of Soviet occupation, the independence of small and medium-sized businesses was progressively curtailed, culminating in nationalization in 1972. The state enterprises were combined into horizontally and vertically integrated conglomerates; most of them were national monopolies.

7. The reunification of Germany required that the former German Democratic Republic make the transition to an open social market economy as rapidly as possible. In the process, it would be exposed to international competition requiring that private initiative again become the engine of economic development in the new German States. The concept of obtaining customers by manufacturing attractive products at competitive prices in the market-place was a totally new concept to the managers in the former German Democratic Republic. In the past, they were only responsible for attaining their production goals. The Federal Government's strategy to bring them into the market economy was to privatize approximately 10,500 enterprises as fast as possible.

8. Part of the economic unification involved a currency union that went into effect on 1 July 1990, causing an immense shock to both citizens and business enterprises in the former German Democratic Republic. There was no period of transition to a hard currency economic system - it happened in one day. The exchange rates of marks to deutsche marks were not based on relative values generated by the market-place - the exchange rates were based purely on political considerations.

9. The result of this immediate currency union was that manufacturing enterprises in the former German Democratic Republic lost substantially all of their export markets for their goods, mostly because of their dependence on countries belonging to the former Council for Mutual Economic Assistance. Those countries were no longer able to purchase goods from enterprises of the former German Democratic Republic at prices based on former exchange rates - purchases had to be made in deutsche marks at unattractive rates. Under the old system, since customers were more or less guaranteed, managers had no marketing experience. This meant that many enterprises decreased or ceased production, which made the privatization exercise more difficult.

10. The law on privatizing and reorganizing state property (Trusteeship Act), passed by the Parliament of the former German Democratic Republic on 17 June 1990, assigned the task of privatization to the Treuhandanstalt. On 3 October 1990, the Treuhand became a special administrative agency of Germany and its holdings are indirect holdings of the Federal Government. It has been charged with reducing the state's business activity as quickly and as much as possible through privatization, putting as many enterprises as possible on a competitive footing, and making real estate available for commercial purposes.

11. After achieving German unity, the central task of the Government is to quickly revive the stalled East German economy through investment by German and foreign investors. The Treuhand facilitates investment by speedily privatizing, and reorganizing enterprises for privatization, as well as by making available real estate for setting up businesses. Priority is given to privatization over reorganization and, as far as possible, to privatizing reorganized enterprises.

B. Economic, financial and social conditions in the country

1. Availability of local capital

12. Domestic and foreign capital is available for investment in privatization. The banking system is well-developed and has been extended to the new part of Germany. Special programmes have been developed to give support in special cases, such as management and employee buy-outs.

2. Existence of capital markets

13. The stock exchanges in Germany are highly developed. There are about 450 domestic joint stock corporations listed on the exchanges, but no corporation headquartered in the former German Democratic Republic has been listed so far.

14. Under section 65 of the Federal Budget Code (19 August 1989), participation in a business enterprise can only be justified by an important interest on the part of the Federal Government. In 1983-1984, there was a comprehensive review of such interests, which led in several cases to the decision to withdraw completely from the ranks of shareholders in certain enterprises. An example of this situation is the case of Lufthansa Airlines. At the time that Lufthansa was incorporated, private investors were not ready to organize a national airline.

15. This was a change from the privatization policy of the 1960s in one important respect: at that time the Federal Government retained important holdings in privatized companies in the interests of the small shareholders and the company itself. There was no objective justification for this in the 1980s. The large industrial groups in which the Federal Government participated had by the 1980s reached the stage where they could survive

without government backing in competition in the free market either alone as companies listed on the stock exchange or in business associations. The Federal Government sold all its shares in VEBA AG, Volkswagen AG and VIAG AG, in Salzgitter AG and in the Deutsche Industrieanlagengesellschaft mbH.

16. The fears expressed in public discussions by critics of the privatization policy that it would have a detrimental effect on the development of the enterprises and on jobs have failed to materialize. Quite to the contrary, the groups have done very well without government participation. They have been able to plan their group strategies and raise funds on the financial markets free from the administrative and political constraints that government participation inevitably brings with it. Their valuation on the capital markets has improved significantly.

17. The positive development of these groups - the forward-looking consolidation of their position in the markets - is also to the advantage of their employees.

18. Even in the case of partially privatized companies, opening up share ownership to a wider circle has lent new impetus to entrepreneurial activity. The daily consultation on the firm's performance on the stock market and the need to answer to a much expanded general meeting of shareholders have had an invigorating effect.

19. The 20 transactions reducing government holdings since 1983 comprised 11 broadly dispersed national and international placements of shares, three option loans and six share reductions not through the stock market. At the time of subscription, the share placements achieved a wide dispersion. At present, Volkswagen AG, VEBA AG, VIAG AG and Preussag AG are counted among the great German public companies. In this group, Volkswagen AG and VEBA AG have the largest numbers of shareholders.

20. The largest stock sales - more than DM 1 billion volume - VEBA AG, in 1987, and Volkswagen AG and VIAG AG, in 1988, were in the form of international placements, that is, the syndicate included experienced foreign banks as well as German banks. The privatizations increased the capacity of the stock market, strengthened Germany as a financial centre and had a positive influence on the international cooperation of the placing banks.

3. Socio-political considerations

21. In its privatization resolutions of 1985, the federal cabinet stipulated that when Federal Government holdings are being reduced, as far as possible the aim of broad dispersion should be pursued. In particular, efforts by the enterprises concerned to offer shares to their employees should be supported. The Government considers that employee ownership of shares is necessary in a market economy because it helps to avoid social conflicts.

22. When putting the privatization resolutions into effect, the managing boards of directors have offered shares to their employees in all cases where the objective was to achieve broad dispersion of share ownership. This was done in various forms and met with various levels of interest:

(a) In the first privatization, VEBA AG acquired shares from the Federal Government's holding and offered them to the employees, and later did the same with shares resulting from capital increases. Between 1984 and 1985 more than 60 per cent of the employees had already acquired such shares;

(b) In the year of its privatization (1988), Volkswagen AG made one of its shares available to each employee;

(c) In 1987, Deutsche Lufthansa AG decided to increase its approved capital by DM 30 million, which has so far been issued as employee shares in two phases. About half of the domestic staff have used these shares as a capital-forming investment;

(d) Some 80.3 per cent of the 918 employees of Deutsche Verkehrs-Kredit-Bank AG and 62 per cent of the 824 employees of Deutsche Siedlungs and Landesrentenbank have bought shares in their companies;

(e) In 1986, 2,163 employees of Industrieverwaltungsgesellschaft (that is, 50 per cent of the total) purchased shares in their company;

(f) At VIAG AG, 14,000 employees (48 per cent of the staff) subscribed for employee shares in 1985, and in 1988, 12,100 employees (41 per cent of the staff) subscribed.

23. The privatization of equity interests of the Federal Government has made management and staff more aware of the concept of employee shares and has successfully achieved the objectives of the Federal Government. In the former German Democratic Republic, all enterprises were state-owned, but in the future, employees will be given the same opportunities to purchase shares in their companies as the employees in the western part of the country received.

II. PRIVATIZATION METHODS USED IN GERMANY

24. The privatization methods described below are being used in both the former Federal Republic of Germany and the former German Democratic Republic.

A. Contracting-out

25. The technique of contracting-out is used if public services are done less expensively by private enterprises. Economic services are to be provided primarily by the private sector companies that are mutual competitors. For example, contracting-out is being done for vehicle and machinery maintenance, for the development of technical norms or standards and for services such as cleaning government office buildings and refuse collection.

B. Deregulation

26. In Germany, as in most member States of the European Community (EC), statutory regulations against private restrictions of competition are held in high regard. As a result, Germany has a highly developed system of competition law along with an agency to enforce the relevant norms. This policy of the Government led to the decision to privatize all of the state-owned monopolies of the former German Democratic Republic.

C. Trade sales

27. Trade sales are the most common method used by the Treuhandanstalt to promote privatization in the former German Democratic Republic. The advantage is that the purchase price can be negotiated between the Treuhandanstalt and the investor. The investor is asked to present a management plan for the continuation of the enterprise and its restructuring if needed. The new investor's capacity to manage and to invest has proved to be superior to that of existing management where the enterprise was privatized through public offerings. Trade sales are also the most rapid way to privatize. The Treuhandanstalt has been avoiding time-consuming methods of privatization such as public offerings, wherever possible, since delays can lead to losses. The short time factor, however, could give the bidder the chance to purchase the enterprise at a lower bid.

D. Management and employee buy-outs

28. The technique of buy-outs is also used by the Treuhandanstalt to privatize enterprises that require relatively small capital investments, such as garages and workshops. Managers and employees are welcomed as investors, but they have to compete with other investors. If there is a trade sale, the Treuhandanstalt has the power to grant advantages to purchasers, such as delays for payment.

E. Joint ventures

29. Joint ventures were created in the beginning of the transition period, but now this technique is less popular than trade sales or management-employee buy-outs.

F. Share offerings

30. As described above, public share offerings were used in the former Federal Republic of Germany when large amounts of capital had to be raised and when widespread ownership was a major objective. This technique generally creates the most public awareness of the privatization process. It is also the most technically difficult approach, requiring considerable care in

choosing the state-owned enterprise candidate and carefully planning the details of the flotation. Public share offerings have not yet been done for the enterprises located in the former German Democratic Republic.

III. IMPLEMENTING THE PRIVATIZATION PROCESS

A. The privatization programme in the former Federal Republic of Germany

31. To achieve its privatization objectives, the Government reorganized and strengthened certain enterprises and modified its policies on public ownership of others. First, government-owned firms that were operating at a loss were reorganized. To diminish the drain on the state budget, the first priority was to eliminate the source of losses. For example, in 1982-1983, the steel, shipbuilding and processing group Salzgitter reported a group loss of DM 721 million. A new group policy was immediately drawn up and put into practice, with the agreement of the owners, the managing board, the supervisory board and the employees of the enterprise. As early as 1984-1985, the group was making a profit again and after five profitable years, in 1989, it was able to pay dividends for the first time since 1960-1961 and was ready for privatization. The group was sold in late 1989.

32. Another example is the Volkswagen group, in which the former Federal Republic of Germany had a minority interest of 20 per cent after 1961. Volkswagen had a DM 300 million loss in 1982 and in 1983 showed a further negative result of DM 215 million. Since 1984, it has been possible to improve the group's results in every year. Volkswagen is now able to operate in the top ranks of the members of the international automobile industry. The former Federal Republic of Germany sold its holdings in 1988.

33. During the 1970s, the enterprise groups with government ownership operated an expansive holdings policy under the motto "diversification". In numerous cases, that strategy was not successful. In 1983, therefore, the heads of the enterprises were advised to review their holdings and to streamline them. This was subsequently done. Furthermore, the government-owned industrial groups exercised restraint in the acquisition of additional holdings.

34. By March 1990, the groups in which the former Federal Republic of Germany had a majority interest had sold, reduced or renounced holdings at home or abroad in about 75 enterprises. For example, the Saarberg group has separated itself from its four holdings in the German tool industry. In addition, the Federal Government has sold off all its shares in several other groups, resulting in the groups being dropped from the annual report of the Federal Government on its holdings.

35. It was possible to reduce the holdings of the former Federal Republic of Germany significantly (direct holdings, including its first- and second-tier subsidiaries) without special funds, which by 1982 had greatly grown in

number. After a record level of 808 federal government participations in 1982, by the end of 1989, the number of investments had been reduced to 132.

36. By 1990, a considerable amount of budget receipts from privatization sales (DM 9.9 billion) had been realized. This included revenue from the Reconstruction Loan Corporation and the German Federal Railway Special Fund of DM 500 million. Furthermore, the federal budget was freed of enterprises' demands for capital resources to finance their further growth. What cannot be quantified is the relief afforded to enterprises by sales of participations in their group.

37. After their complete privatization, the groups once owned by the former Federal Republic of Germany, had, as early as 1989, already borrowed over DM 3.4 billion in the capital markets. These capital increases were no longer - not even partially - a burden on the federal budget.

B. The privatization programme in the former German Democratic Republic

1. Transition from a planned economy to a free market economy

38. There are three main steps in the transition from the planned state economy to the free market economy:

(a) Conversion of state-owned enterprises and branches operated in forms established under public law, such as the publicly owned enterprises (volkseigene Betriebe) and combines (Kombinate), to legal forms customary under private commercial law and under the law relating to cooperatives, with simultaneous adjustment to international standards - particularly EC standards;

(b) Creation of adequate equity capital for enterprises so that they will be able to compete in a market economy. Here there will have to be a fundamental reform of accounting principles to conform to international standards, particularly the Fourth and Seventh Directives of the Council of the European Communities;

(c) Sale of state enterprises to entrepreneurs and private investors.

2. The legal framework

39. To make the transition to a market economy, the traditional basic legal structure for commercial enterprise needed to be reintroduced. This included the common business forms of sole proprietorships, partnerships and corporations.

40. After 1 July 1990, the Trusteeship Act (Treuhandgesetz) in Germany converted the so-called popularly owned enterprises into private limited companies and the so-called popularly owned conglomerates into public

companies limited by shares (joint stock corporations). This Act also stipulated that after 1 July 1990 enterprises became owners of the assets (including land) that had been legally used by them (by way of so-called Rechtsträgerschaft). These measures have helped enterprises particularly to build up equity and to establish their creditworthiness to creditors, especially to banks.

41. In the case of the former German Democratic Republic, the Assets Act (Vermögensgesetz) has been passed, which together with the Unification Treaty, will restore to rightful owners arbitrary expropriations and nationalization of properties. If this is not possible, people will be given compensation.

3. The work of the Trust Agency in the privatization process

42. The Trust Agency (Treuhandanstalt) was established in the form of an institution under the Trusteeship Act for the privatizing of former state-owned assets. Initially, in addition to the 10,500 companies that were planned for privatization, there were 25 billion square metres of land and 9.6 billion square metres of forests for sale. The Trust Agency is subject to the supervision of the Ministry of Finance. It has the task of selling enterprises to investors - including private investors. The goal is for complete privatization. If partial privatization is unavoidable, complete privatization should be planned and, if possible, assured for a later date.

43. The sale of Treuhand assets are governed by the following procedural principles:

(a) Properties for sale should be widely publicized both at home and abroad to reach as many prospective buyers as possible so that the best of several competing offers may be chosen;

(b) Small and medium-sized firms should get a fair chance to purchase such properties;

(c) Negotiations should be as transparent and objective as possible in order to afford equal treatment to all prospective buyers and to avoid discriminating against smaller and foreign applicants in particular.

44. In reviewing proposals for privatization of enterprises, the Trust Agency considers the following matters:

(a) A practical and achievable business plan for the next three and a half years;

(b) A commitment to guarantee employment for the workers;

(c) A commitment for capital investment in the enterprise;

(d) Assistance with the disposal of land and buildings not required for operations;

(e) A willingness to take responsibility for at least part of environmental risks and liabilities for previous environmental damages;

(f) A purchase price for the enterprise that is realistic and reasonable.

45. From the inception of its operations through 31 December 1991, the Treuhandanstalt has sold nearly 5,000 enterprises or branches of enterprises, including 24,000 retail stores, and has received US$ 8 billion in proceeds. The purchasers of the businesses have guaranteed the jobs of 900,000 workers and have committed to make capital investments of US$ 70 billion in the enterprises. Approximately 200 of the purchasers are foreign (primarily from France, Switzerland, the Netherlands and Sweden), and approximately 900 of the enterprises were privatized by management-employee buy-outs.

46. Foreign investment in former German Democratic Republic enterprises has not been as great as the Trust Agency or the Federal Government would like. Of course, the large number of companies for sale greatly depressed the market for such investments. To stimulate investment, all investors (domestic and foreign) in the new States of Germany are eligible for the following subsidies:

(a) Investment premium (discount on the purchase price) by the Federal Government: 12 per cent of the cost of the acquisition and the cost of manufacturing if the economic goods have been acquired or produced between 30 June 1990 and 1 July 1991. For the period from 1 July 1991 until 30 June 1992, the investment premium is 8 per cent. The investment premium, which is granted upon application, is tax free and does not reduce the depreciable value of assets;

(b) Investment grants by the Federal Government. Grants are made within the framework of regional promotion and can amount to up to 23 per cent. They are granted for the establishment, renovation and fundamental rationalization of a commercial enterprise. A predominantly national sale of the goods produced, as well as the creation and safeguarding of a sufficient number of permanent jobs, is the prerequisite. There is no legal right to these investment grants; they are only granted for particular lines of business deserving aid (especially manufacturing, wholesale and catalogue sales trading). Investment grants reduce the depreciable value of assets for tax purposes;

(c) European Recovery Programme loans of the Reconstruction Loan Corporation and the German Equalization Bank. German businesses, as well as foreign businesses that establish an independent subsidiary in the new Federal States or take part in a business there (joint venture), are entitled to apply for loans. The interest rate at the end of 1991 was 7.2 per cent per year. The term of the loans is 20 years and no payments are due in the first year of the loan.

IV. IMPLICATIONS OF PRIVATIZATION FOR ACCOUNTING

A. The Deutsche Mark Accounting Act

1. Introduction

47. In a market economy, enterprises survive only if they have adequate capital and if their earnings are sufficient to finance investments and to produce profits. This was not as important in a planned economy because capital could be shifted by Government among enterprises. Accounting mainly served the purpose of monitoring the fulfilment of production targets and not the determination of profits.

48. Consequently, the previous accounting system is not adequate for the proper business management of enterprises. Also, it could not provide useful information to investors and lenders without adjustments to conform to internationally accepted standards. To this end, the Deutsche Mark Accounting Act (D-Markbilanzgesetz or DMBilG) was passed on 23 September 1990, together with the Unification Treaty. The DMBilG, which was amended and promulgated in a new version on 26 April 1991, 2/ obliged enterprises in the former German Democratic Republic to prepare opening financial statements for 1 July 1990, comprising a balance sheet and the related footnotes, a revaluation of assets and liabilities and an adjustment of equity capital. The Act also prescribed auditing and reporting requirements. The revaluation must be carried out in conformity with international standards as set forth in the Fourth and Seventh Directives of the Council of the European Communities. This Act is of considerable importance because it forms the basis for future accounting and reporting. Owing to the fact that in Germany commercial accounts are also used for taxation purposes, the new values will also be used to determine taxable income.

2. Preparation of the opening balance sheet and the reorganization plan

49. The deutsche mark opening balance sheet and the notes thereto are required to give a true and fair view of the enterprise's assets and liabilities. The existing management of enterprises of the former German Democratic Republic lacked the training and experience in western accounting and so were not equipped to produce either an accurate opening balance sheet or a realistic reorganization plan. Consequently, external advice was taken from accounting firms, management consultants and valuation experts. Despite their familiarity with the EC directives and accounting systems geared for the market economy, they encountered a number of problems, discussed in the following section, which considerably slowed down the process. In particular, there was a problem with the quality of the accounting data and the fact that they had to be transformed from one system to another.

50. The opening balance sheet and the reorganization plan were supposed to indicate to the Treuhandanstalt whether the enterprise was capable of surviving. The opening balance sheet, drawn up in a format in compliance with the Fourth Directive, was to represent a starting-point for the bookkeeping after the currency reform. The Fourth Directive requires that the balance sheet be based on the historic cost principle, but if statements were based on historic German Democratic Republic marks, they would not be very meaningful. Therefore, it was decided that monetary items would be converted into deutsche marks at 2:1, land and buildings would be valued at something related to market price and inventories would be valued at net realizable value or replacement cost.

51. Other problems arose since land records did not always correctly reflect what properties were used by the enterprises. It was also necessary to deal with the claims of the former owners.

52. Where an enterprise has a majority holding in another enterprise, it is required to draw up a consolidated opening financial statement comprising an opening balance sheet and notes on the consolidated accounts. This does not apply unless the following size criteria are exceeded: DM 50 million or 500 employees. In principle, the rules regarding group accounting under the Commercial Code are applicable, with due consideration being given to the special aspects applying to a deutsche mark opening balance sheet. The Trust Agency is required to draw up consolidated opening accounts in simplified form.

53. The deutsche mark opening account has to be audited in compliance with the commercial code. Exceptions are made in the case of sole proprietorships and unlimited partnerships and small private limited companies.

54. The other document that is central to the privatization process is the reorganization plan. The document contains a three and a half year business plan for each operating unit which includes a strategy for marketing, personnel and production. These two documents, the opening balance sheet and the reorganization plan, made a logical starting-point for the privatization exercise. However, investors would be more likely to base their decisions on the enterprise's future prospects than on the value of equity as shown in the balance sheet. The opening balance sheet could serve as a useful check-list of assets and liabilities that were to be transferred to the new enterprise. However, the opening balance sheet was not necessarily a useful guide for valuation.

3. Valuation

55. As a general principle of valuation, it was assumed that the enterprises would continue their activities (going concern). The balance sheet shows those assets and liabilities that are to be taken over, together with "the business" as such, and is essential in arriving at a purchase price. A number of specific problems have arisen in the valuation process, such as:

(a) Real estate. The market value was difficult to estimate because there was no market for the land and buildings. The valuation methods used involved comparisons with properties in similar cities and towns in western Germany. Considerable fluctuations are expected for these valuations in the next few years as the former German Democratic Republic is assimilated into the united country;

(b) Buildings. Most valuations were done by western appraisal experts. The status of maintenance and the need for repairs had to be considered, as well as asbestos risks and whether the buildings could continue to be used as intended or there was idle capacity or unsuitable locations;

(c) Machinery and equipment. Comparisons with similar types of equipment in use in other countries was difficult. Factors such as the status of maintenance and the need for repairs, technical obsolescence and continued usefulness in production had to be considered;

(d) Inventories. Overstocking of finished goods and raw materials, and particularly spare parts for machinery and equipment, were common. Possible obsolescence caused by changes in markets for products produced had to be considered when valuing the inventories;

(e) Liabilities. Accruals for social costs of employee reductions, losses on uncompleted contracts and environmental clean-up costs were difficult to value.

56. Provisions, commitments and accruals were recognized, especially for environmental damage. If provisions were needed in the past but were not made, a special loss account was set up on the asset side of the balance sheet at the value of the provision, which, in turn, resulted in a balancing item within the equity capital section.

57. Many value judgements were required in this exercise - more than were normally required in valuing businesses in the west. Some cases of excess conservation and of overoptimism naturally occurred, particularly in view of the shortage of time to complete the work. Consequently, the valuations in the deutsche mark opening balance sheet can be changed if during the preparation of subsequent annual accounts it appears that recognition or valuation/measurements were incorrect and that the sums involved are material. But the items can also be changed for the purpose of the subsequent exercise of an option, given for the deutsche mark opening balance sheet, which will have a corresponding opposite effect on the later balance sheet. Correction is effected in the following year's financial statements; the deutsche mark opening balance sheet is then deemed to have been altered. Changes can be made in the annual accounts until the financial year ending in 1994.

58. Recently, there has been criticism that some former German Democratic Republic business enterprises have been sold at very low prices, based upon the valuation of individual assets and liabilities. The Government has now directed the Trust Agency to revise its valuation guidelines and value enterprises at their fair market values as a going concern.

B. Capital adequacy

59. In the majority of enterprises of the former German Democratic Republic, revaluation of assets was not enough to solve the problem of capital adequacy. To avoid liquidation or bankruptcy and to ensure minimum capital, the Deutsche Mark Accounting Act provides that former state enterprises will have an equalization claim against their parent enterprise if, as former state enterprises, they were transferred to the Trust Agency or to other enterprises for the purpose of privatization and if they were in their exclusive possession on 1 July 1990. The equalization claim amount is the sum that would otherwise have to be shown as the "loss not covered by equity capital" within the meaning of section 268 of the Commercial Law (HGB). The parent enterprise may, as debtor, reject the equalization claim within three months of submission of the adopted deutsche mark opening balance sheet. If the parent company rejects the claim, the claim must be written off. The enterprise will have to go into bankruptcy if the over-indebtedness is not balanced by other means. To equalize its liabilities, the parent enterprise will enter a participating depreciation account, to the extent of the equalization claim, on the asset side of the opening balance sheet, which, being a loss account, is recognized for tax purposes.

60. Conversely, those enterprises with excess capital will transfer the surplus capital to the Trust Agency in the form of an equalization liability.

61. Under section 25 of the DMBilG, if equity capital, after deduction of special-purpose reserves, is higher than tangible fixed assets less real estate transferred on 1 July 1990, the amount must be paid to the parent enterprise (in most cases, this is the Trust Agency).

62. A capital revaluation has to be made by all enterprises having a subscribed capital because of the currency conversion. The subscribed capital has to be created at least to the extent of the minimum capital required by the legal form of the enterprise. The surplus equity capital less special-purpose reserves has to be allocated to a special-purpose reserve in the interest of protecting creditors, and this special-purpose reserve may only be used for offsetting losses. If on capital revaluation it appears that the equity capital less special-purpose reserves is insufficient for creating the minimum subscribed capital, former state enterprises have to record a receivable on the asset side of their balance sheet. The receivable is collectible from the enterprise's parent (in most cases, this is the Trust Agency).

63. Provisional capital revaluations are also permissible in the form of a "capital depreciation" account on the asset side of the opening balance sheet. This capital depreciation account may be fixed at the sum representing the difference between available equity capital and the nominal amount of the subscribed capital shown in the closing balance sheet. But the amount shown in the capital depreciation account is not allowed to exceed nine tenths of the subscribed capital: this is 10 times the amount of the available equity capital. The capital depreciation account has to be written off within five years. To help, enterprises are allowed to capitalize revenues if they can be expected to be realized in the future.

64. Under certain conditions, all enterprises may capitalize the production costs of intangible assets not acquired by a purchase (which normally is not allowed). This will be offset by an amount called a "provisional earnings reserve" with the equity section of the balance sheet. This is only allowed if - after a reasonable commercial assessment - it is believed that the enterprise will be in a position to cover the amortization of the intangible asset against its current revenues without impairment of the equity capital shown in the opening balance sheet.

65. Privatization in Germany has been rather unique in that, in the former Federal Republic of Germany, it has occurred on a slow, deliberate, phased basis, while in the former German Democratic Republic, it is occurring on a massive and rapid basis, with the Treuhand directly selling off approximately 20 enterprises each day. All of the retail and wholesale trading firms, banks, insurance companies and public utilities in the former German Democratic Republic have now been privatized (approximately 24,000 enterprises).

Notes

1/ The present case-study is based in part on written contributions from the Ministry of Justice of Germany and on observations from practising accountants.

2/ Federal Law Gazette, I, p. 971.